JONES DAY

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REFORMS TO THE UK CONTROLLED FOREIGN COMPANIES REGIME

Government proposals to simplify tax rules while promoting the interests of business are always welcome, and this is especially true of the proposed reforms to the United Kingdom's Controlled Foreign Company ("CFC") legislation. The Government has released the final legislation as part of the Finance Bill 2012 after much discussion and consultation. The new regime will apply to accounting periods of CFCs beginning on or after 1 January 2013.

In this *Commentary*, we provide a summary of the history of the CFC rules and discuss the proposed changes. We also consider the opportunities that the new legislation presents for multinational businesses.

The new regime will allow some UK multinational companies that are currently taxed under the CFC regime to fall outside the scope of the new rules. For companies looking to expand into the UK or considering an expansion into Europe through the UK, the new CFC regime should make the UK a more attractive place for such businesses.

HISTORY OF THE CFC RULES

The UK introduced CFC rules in 1984 in response to a perceived increase in tax deferral and artificial diversion of profits to lower-tax jurisdictions following the relaxation of UK exchange controls. Such rules are a common feature of many tax systems that seek to bring profits accumulated outside the jurisdiction within the charge to tax. For example, the rules contained in Chapter 1, Subchapter N, Part III, Subpart F of the US Internal Revenue Code seek to bring the income of US CFCs within the scope of US tax.

CURRENT CFC RULES (FOR ACCOUNTING PERIODS BEGINNING BEFORE 1 JANUARY 2013)

Under the current UK rules, where a company is a CFC and does not fall within one of the specified

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exemptions, all the profits of that CFC may be apportioned among its participators (broadly, its shareholders).

A company is a CFC where the following three criteria are met: (i) the company is not resident in the UK; (ii) the company is controlled by UK residents; and (iii) the company pays a lower level of taxation (i.e., less than 75 percent of the tax that would have been paid had the company been resident in the UK).

A CFC can fall outside the scope of the rules and therefore avoid an apportionment of its profits if it satisfies any one of the following five statutory exemptions. These exemptions are parallel tests, in that they may be applied in any order.

The exemptions exclude CFCs that: (i) have profits below the *de minimis* limit[1]; (ii) operate an acceptable distribution policy[2]; (iii) carry on certain exempt activities[3]; (iv) are resident in certain excluded countries[4]; or (v) do not have a tax avoidance motive[5].

Where the exemptions do not apply, any UK corporate participator whose apportionment is 25 percent or more of the CFC's profits (including apportionments made to persons connected or associated) will be subject to UK corporation tax, with an allowance made for any foreign taxes paid by the CFC.

CHALLENGES TO THE CFC RULES

The decisions of the European Court of Justice ("ECJ") in the *Cadbury Schweppes*[6] case and the Court of Appeal of England and Wales ("Court of Appeal") in the *Vodafone 2*[7] case have left the validity of the current CFC rules in doubt. Accordingly, in addition to introducing a simpler, more business-friendly set of rules, the new CFC regime is also intended to be European Union law compliant.

In the *Cadbury Schweppes* case, the ECJ was asked to rule on whether the UK's CFC rules were an infringement of the freedom of establishment principle. The ECJ ultimately held that Cadbury Schweppes had not engaged in an abuse of the freedom of establishment principle by establishing subsidiaries in lower-tax jurisdictions but that the CFC rules did hinder the freedom of establishment. Importantly, however, the ECJ ruled that the restriction on the freedom of establishment imposed by the UK's CFC rules could be justified where it was both in the public interest and proportionate. The UK had argued that such a restriction could be justified on the grounds that it was in the public interest to prevent tax avoidance; however, this was rejected by the ECJ, which instead held that the CFC rules could be justified only where the rules related to "wholly artificial arrangements…".

That position was further compounded by the decision of the High Court of England and Wales ("High Court") in the *Vodafone 2* case, which stated that the CFC rules should not apply to companies with subsidiaries in European Union ("EU") or European Economic Area ("EEA") Member States, owing to incompatibilities with the Treaty establishing the European Community. The Court of Appeal overturned the decision of the High Court, instead deciding that the CFC rules could apply to subsidiaries in EU/EEA Member States subject to the implied exception that the rules did not apply to companies carrying on "genuine economic activities."

NEW CFC RULES (FOR ACCOUNTING PERIODS BEGINNING ON OR AFTER 1 JANUARY 2013)

In broad terms, the new CFC rules have moved towards an "all out unless in" approach that facilitates intra-group activities and offers businesses the flexibility to self-assess their obligations under the new CFC rules.

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1 CFCs with profits of less than £50,000 or, for accounting periods beginning on or after 1 January 2011, less than £200,000 are exempt from the CFC regime.
2 No CFC charge will arise where not less than 90 percent of the CFC's profits are distributed for periods prior to 1 July 2009.
3 Entities which can satisfy a series of prescriptive conditions to establish that their main purpose is not to reduce UK tax are excluded from the CFC rules, although in practice, satisfying this exemption can be difficult.
4 CFCs resident in certain jurisdictions will be exempted in whole or in part from the CFC regime.
5 Through a series of sub-tests, this exemption provides a final opportunity for CFCs to fall outside the CFC regime where the previous objective tests have failed to exclude companies not set up for the purposes of tax avoidance.
6 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* C-196/04 [2006] ECR I-7995.
7 *Vodafone 2 v The Commissioners of Her Majesty's Revenue and Customs* [2008] EWHC 1569 (Ch).

The new rules are intended to reflect the decision of the Court of Appeal in the *Vodafone 2* case by subjecting overseas profits to UK tax only where there is an artificial reduction of UK tax. In addition, the CFC charge will be proportionate, by targeting only those profits that have been artificially diverted away from the UK, rather than applying to all profits of the CFC which are caught (subject to exceptions) under the current regime.

The new rules introduce a "gateway test" and safe harbours, reframe the exemptions as entity level exemptions and provide a specific exemption for finance companies. Broadly, the criteria for establishing whether a company is a CFC have been retained, although the requirement that a lower level of taxation is paid by the company has been removed from the CFC test and included as an entity exemption.

The Gateway Test. One of the most significant changes to be introduced under the new regime is the "gateway test" which defines those profits that are to fall within the scope of the regime. This differentiation of profit streams represents a significant improvement on the current regime and provides the initial mechanism for the new "all out unless in" approach. In addition, the gateway test will serve to exclude a significant proportion of entities from the scope of the CFC rules, even before the other exemptions need be considered.

In February 2012, the new rules were further improved upon by the inclusion of an "introductory" Gateway Chapter (Chapter 3) to the legislation. This chapter will reduce the compliance burden by acting as a pre-gateway test enabling companies to test whether the specific gateway chapters require consideration.

The substantive chapters of the gateway test then assess whether any of the CFC's business and finance profits may be subject to the CFC charge by determining whether there has been an artificial diversion of profits from the UK.

One of the key tests of whether there has been an artificial diversion of profits is whether there is a significant mismatch between key business activities undertaken in the UK and the profits arising from those activities allocated outside the UK. The following three specific requirements must be satisfied in order to establish whether this significant mismatch occurs: (i) the majority of the profits from the assets or risks owned or borne by the CFC are connected with the UK activity by reference to "significant people functions" ("SPF") in the UK[8]; (ii) the separation of assets or risks from activities does not give rise to substantial non-tax value; and (iii) the arrangement that creates this separation would not be entered into between independent companies.

Safe Harbours. Specific profits of the CFC are excluded from the CFC rules by the operation of various safe harbours. This represents a significant departure from the approach of the current regime which subjects all CFC profits to tax unless an exemption is satisfied. Profits dealt with by safe harbours include: profits from property businesses; incidental non-trading finance profits; incidental non-trading finance profits derived from the investment of funds held for the purposes of a trade or property business where the profits of the trade would not themselves fall within the CFC rules; and incidental non-trading finance profits where a "substantial part" of the CFC's businesses is holding shares and securities in its 51 percent subsidiaries.

Entity Level Exemptions. As an alternative to the gateway test, companies can use the "entity level exemptions" to fall outside the scope of the new CFC rules. There are similarities between these exemptions and the various exemptions that exist under the current rules. These exemptions are targeted at CFCs which pose a low risk to the UK tax base. The specific exemptions include a low profits exemption (similar to the current de minimis rule), a low profit margin exemption for CFCs whose accounting profits are 10 percent or less of their cost base and related party expenditure, an excluded territories exemption (similar to the current excluded countries test albeit subject to certain conditions) and a temporary period of exemption of 12 months for companies that will be new to the UK CFC regime (for example, either because they were acquired by a UK company or the parent company has migrated to the UK), during which a foreign subsidiary will be exempted from the CFC rules subject to the CFC undertaking any restructuring necessary to ensure that no CFC charge arises for subsequent periods.

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8 The principles for the identification of SPFs are set out in the 2010 OECD report on the Attribution of Profit to a Permanent Establishment.

Finance Company Exemption. The finance company exemption is intended to allow multinational entities to manage their intra-group financing arrangements more effectively. Under the Finance Company Exemption, the profits of intra-group financing companies will effectively be taxed at 25 percent of the normal corporation tax rate, which will be 5.75 percent if the corporation tax rate is reduced, as proposed, to 23 percent for 2014. This exemption will work by considering the finance company's debt-to-equity ratio and applying a CFC charge to the extent that the company has excess equity.

The partial exemption has been extended to a full exemption in situations where either the CFC charge that would arise from partially exempt loan relationships is limited to the aggregate net borrowing costs of the UK members of the group or the finance profits arise from a qualifying loan (broadly, a loan made to a connected foreign company) which is made without reliance on wider group funds (for example, as a result of a rights issue).

THE BIGGER PICTURE

The proposed changes to the CFC rules demonstrate the UK Government's desire to make the UK a more attractive place from which multinational entities can conduct their operations. However, they are but one of many aspects of the UK tax system that will go towards achieving this goal.

The new CFC rules combined with the general exemption from corporation tax on dividends received by UK companies, the absence of withholding tax on dividends paid by UK companies, the option to elect to exempt profits of overseas branches from corporation tax, the corporation tax exemption with respect to disposals of shares in subsidiaries in certain situations and the UK's extensive tax treaty network—all of these factors make the UK an attractive location for multinational entities considering establishing or expanding their business operations in the UK and worldwide.

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